Canada

**Prices and incomes commission**

**Commission des prix et des revenus**



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Submission to the
Standing Senate Committee on National Finance
Hearings on Growth, Employment and Price Stability,
by the
Prices and Incomes Commission,
May 25, 1971.



John H. Young
Chairman

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The Prices and Incomes Commission was appointed June 19, 1969, with terms of reference extending to Dec. 31, 1971, "to inquire into and report upon the causes, processes and consequences of inflation and to inform those making current price and income decisions, the general public and the Government on how price stability may best be achieved".

During the two years in which the Commission has been in operation much of what we have had to say in public on these matters has been directed to those making current price and income decisions. We now are in the process of drawing on our operating experience and the results of our research program in putting together a report to the general public and the Government on the subject of inflation and on the part which might be played by a prices and incomes policy in the management of the economy.

This work is still going forward and we are not yet in a position to offer your Committee a set of firm conclusions. The Committee may, however, find it useful to know what we regard as the central issues which need to be resolved, and might also be interested in having some preliminary observations on prices and incomes policy based on our experience to date in this area.

The central problem to which we have been addressing ourselves is how Canada can achieve and maintain an acceptable level of employment without the kind of cost and price increases which prevent this level from being sustained. On two occasions since the early '50s when we have been moving ahead rapidly from slack conditions toward high levels of activity and employment, the economy has overshot the turn on to a sustainable growth path and has run instead into a sharp upsurge of substantial price and cost increases. In both instances the subsequent attempt to get the economy back on track has involved a prolonged and painful detour. This is a problem which has been encountered by virtually every country in the western world over the course of the last generation, and which at present is causing more serious difficulties than at any previous time in modern history.

While it is generally recognized that this problem is wide-spread, persistent and intractable, there is an understandable human urge to find a simple solution for it.

Thus, when confronted with the awkward fact that there are limits to how high a level of employment can be achieved solely through the rapid expansion of demand

without generating a substantial upsurge of price and cost increases, there are those who argue that the answer is simple - the upsurge of inflation should be accepted as a necessary cost of high employment.

If the choices available were as narrow and simple as this, most people would probably be prepared to accept larger price increases in exchange for less unemployment. Unfortunately, there are strong reasons for doubting that such a simple choice is in fact open to us over any extended period except on the assumption that people can be relied upon not to learn from experience or adjust their behavior accordingly.

This is not to deny that a temporary reduction in unemployment to unusually low levels is likely to occur as demand pressures are becoming so strong and wide-spread that they set prices and costs rising at a substantially faster pace than people expect. Before long, however, people will cease to be surprised that inflation is running at a higher average rate than in the past. They will come to expect it to continue, and where possible they will adapt their economic behavior accordingly. Thus the central question is to what extent, and for how long, the gains in employment achieved initially by accepting a

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higher rate of inflation are likely to persist once people begin to catch on to the game.

This is a key issue. If we could maintain some additional employment on a continuing basis merely by resigning ourselves to an average rate of inflation in the future that was somewhat higher than in the past, that would be one thing. But if in fact we could do so only by resigning ourselves to a progressively escalating rate of inflation over time, that would be quite another matter, much more serious in its implications. Where, it might be asked, would such a policy lead us, and how would it end?

Economists are in substantial agreement that there are no convincing theoretical grounds for believing that the average level of employment would be higher with prices rising at an average rate of five per cent than with prices rising at an average rate of two per cent, if people anticipated correctly and adjusted fully to the trend of prices. How much higher a level of employment can be maintained by accepting a somewhat higher average rate of inflation, and for how long, thus turns on the practical question of how far it is possible to fool at least some of the people all of the time.

Everyone will have his own interpretation of the empirical evidence bearing on this point. In the Commission's view it would be risky to base policy on a low estimate of the public's ability to learn from, react to, and quite possibly over-react to its experience of substantially rising prices.

Those who argue that it should still be possible under present day conditions to obtain some additional employment and output by accepting somewhat higher rates of price and cost increase than in the past, are counting on the fact that not everyone will be alert enough to see what is happening to the value of money or capable of adjusting fully to it. To the extent that this continues to be the case, it is true that some stimulus to employment will persist from the differential gains achieved by many in the community at the expense of the less fortunate.

There are, however, some awkward problems for governments in taking advantage of this possibility. If a government were in fact prepared to see prices rise at a considerably faster rate in the future than in the past, it might well be expected to admit this fact publicly and to facilitate any necessary institutional changes to help people adapt to the new situation. Thus it might take

steps to encourage the automatic adjustment of wages, welfare payments, pensions, interest rates and similar contractual obligations to increases in the price level. To do so, however, would virtually ensure that the public's adjustment to the new and higher rate of inflation would occur very rapidly and very generally. The resulting gains in employment would necessarily be quite small and short-lived, while the inflationary process would become more explosive.

Indeed, there is yet a further complication. Would people believe that a decision to accept from now on an average rate of price increase of four or five per cent a year, rather than a rate of around two per cent a year as in the past, was the end of the matter? Might they not conclude that they were witnessing merely the first stage of a gradual upward ratcheting of the average size of price increases over time, and take protective action against <u>that</u> possibility? Such an over-adjustment to rising inflation could well lead to lower levels of output and employment than those prevailing at the start of the process.

It was considerations of this kind which played a major part in the decisions taken in Canada and the United States in 1968 to deal firmly with the latest bout of inflation. By that time, after more than three years

of substantially rising costs and prices, it was obvious that the public's expectations and behavior were becoming rapidly adjusted to the idea that inflation would continue and perhaps become even more severe. How else can we explain the size of wage and salary increases asked for by employees and accepted by employers, or account for the level of interest rates at which people were still prepared to borrow? How can we explain the growing tendency in 1968 and 1969 for lenders to insist on special protective provisions in the form of equity participation or other optional features before being prepared to buy long-term securities?

Some observers profess to see the emergence of a pattern of escalating inflation in the experience of a number of overseas countries during recent years, and feel that its early establishment in North America now is a distinct threat. Although the evidence is far from unambiguous, a possible interpretation of events across the world is that we may be in danger of witnessing successive bursts of increasingly severe inflation which are only partially reversed in the interludes between them.

Whether or not inflation is becoming an increasingly serious and intractable world-wide problem in this or some other sense, there can be little doubt that sharp outbreaks of substantial price and cost increases have posed the main obstacle to attempts since the early '50s to operate the Canadian economy under sufficiently strong demand pressure to maintain continuously high levels of employment.

If simply reconciling ourselves to more rapid and chronic inflation than in the past does not in fact offer the ready means of escape from the dilemma that is often suggested, ought we to conclude that the levels of employment at which we would like to see our economy operate on a sustained basis are simply unattainable, and reconcile ourselves to less ambitious but more feasible employment objectives?

It must be admitted with respect to this question that rather limited encouragement can be drawn from the record of our economic experience since the early '50s With the exception of 1953, a year marked by a number of special circumstances, at no time since our national unemployment statistics were established on a regular monthly basis have we managed to achieve an average annual unemployment rate as low as three per cent. Over the

period as a whole the average rate has been in the vicinity of five per cent. A broad decline in the unemployment rate to well-below-average levels occurred in 1955-56 and again in 1964-66. On both occasions, however, it seems clear that a sharp outbreak of substantial cost and price increases was already in the making at a point where these declines still had a considerable way to go.

No one can be complacent about this unemployment record. In part it reflects serious defects in the working of the labor market in Canada in matching people seeking work with available jobs. By international standards Canadian unemployment figures are undoubtedly high, even when allowance is made for the very different nature of the quoted unemployment statistics of most other countries from our own.

It must be recognized, of course, that there are certain characteristics of the Canadian economy which make it unlikely that we can maintain as low average levels of unemployment as many other countries. It should also be recognized that these other countries too face the risk of accelerating price and cost increases when an upsurge in economic activity carries their rates of unemployment significantly below the average levels to which they have become accustomed.

There are certain special characteristics of Canadian unemployment which go some way to account for our comparatively poor record by international standards. These reflect the strong seasonal character of much of our economic activity, the numbers and special problems of young people seeking work in Canada, and the very large and persistent regional differentials in unemployment experience.

Seasonal swings in the total number of people employed, which are actually larger than the total number of people unemployed, occur as a regular feature of the Canadian economy. These swings reflect the extremes of the Canadian climate and the customary seasonal patterns of labor-force participation of many groups in the population.

The problem of high unemployment among young people in Canada is partly a matter of job turn-over, reflecting the difficulty encountered by many new entrants into the labor force in finding permanent employment satisfactory both to themselves and to their employers. It is also the case that in Canada many of those leaving the educational system typically fail to obtain quick placement in a job or in apprenticeship programs, as they normally would in various overseas countries. It is

worth noting that this problem has been becoming increasingly severe. In 1970, persons aged 14 to 24 accounted for 45 per cent of unemployment, though they constituted only 26 per cent of the labor force.

Regionally, the average unemployment rates of the Atlantic provinces and of Quebec have long been considerably higher - and that of British Columbia somewhat higher - than the unemployment rate of Ontario. Only the Prairies, which are predominantly agricultural rather than industrial, have typically had a lower rate than Ontario. Thus the unemployment rate in that province, where much of the country's industry is concentrated, is typically well below the national rate, and for adults in Ontario at the seasonal low point in September, the unemployment rate is smaller still.

Although the reasons for these persistent differences in regional unemployment rates are complex, the implications are clear enough. Demand pressures on the national economy are likely to result in an outbreak of sharp price and cost increases when unemployment in Ontario falls to relatively low levels; but this is likely to occur at a point where unemployment in eastern Quebec, the Maritime provinces and perhaps British Columbia is still quite substantial.

The seasonal, age and regional dimensions of unemployment in Canada are each an indication of deep problems in the economy. They are not simply a reflection of deficient demand, though the magnitude of these problems has tended to be less severe when the over-all unemployment rate was low. Nor are there easy solutions to any of them. In this connection it is worth noting that already Canada is spending a larger proportion of GNP on manpower programs than other western industrialized countries.

The stereotype of unemployment in the minds of many people is probably that of the head of a household who loses his job and then experiences a prolonged period of idleness before becoming re-employed. Precise information with respect to the incidence of such cases is not available directly, but it is clear that most unemployment is not of this sort. Most of those becoming unemployed do not remain unemployed for more than three months - and for many it is as short as one month. Many enter the ranks of the unemployed by joining the labor force, or by leaving their present jobs, not by losing their jobs. A very large proportion are not the heads of households. Nevertheless, there is no doubt that the unemployment figures reflect many very real individual tragedies, and

that both the number and the seriousness of these personal disasters increase markedly with every percentage point increase in the over-all unemployment rate.

For this reason, Canadians are right in insisting that some more effective and more humane way of resolving our high employment-price stability dilemma must be found than simply to accept average levels of unemployment in the future as high as those of the past.

If no quick or easy ways of resolving the dilemma appear open to us, what alternative lines of attack on the problem are we left with?

There are, to begin with, policies of various kinds which over the longer term might help to reduce the minimum levels of unemployment and spare productive capacity at which our economy can operate without generating substantially larger price and cost increases. Most of these policies have been the subject of previous study and in recent years considerable experience with their practical implementation has been acquired in Canada.

These include:

(1) Policies designed to bring about a more ready adaptation of supply to match the pattern of

effective demand. The principal example is manpower policy which, through training, counselling, placement and improving mobility, seeks to help the work force adapt more effectively to the pattern of demand for labor. The idea here is that if workers with the required skills could be drawn more readily to areas of labor shortage from areas of surplus labor, the average level of unemployment could be reduced in a way which did not risk making inflation more rapid. Another example is regional economic expansion, which seeks to attract job-creating capital investment in new productive facilities to areas of surplus labor.

(2) Competition, tariff and other policies designed to lower the level of prices in particular industries in relation to the general price level. Action along these lines is inherently of a once-and-for-all character, but it might be timed so as to dampen the inflationary results of a particular period of excess demand. The advancement of the implementation

date for the Kennedy Round tariff cuts is an example of the application of such policies.

(3) Selective demand policies intended to reduce demand in areas where it is excessive and increase demand in less buoyant regions. The measures taken in the spring of 1969 to discourage commercial construction in major urban centres of Ontario, Alberta and British Columbia are an example of the first, and the measures announced in December, 1970, to expand demand in less buoyant regions are an example of the second.

There are other policies for increasing the efficient working of the economy, such as those concerned with encouraging productivity growth or protecting and informing the consumer, which have made and can make a contribution in dealing with the problem. There are difficulties and limitations in applying all of these policies, but even with greater efforts and more success than we have had in the past, more could be done along these lines.

Whatever the degree of success achieved over the longer term through the application of such policies there will, of course, always be some minimum rate of

unemployment (or range of rates) at which an upsurge of price and cost increases in response to excess demand pressures will become a serious risk - though hopefully this critical range of unemployment can be progressively reduced over time.

In the future as in the past, therefore, the management of demand in the Canadian economy through the application of fiscal, monetary and exchange rate policies will continue to be of central importance in efforts to keep the economy operating at or close to minimum sustainable levels of unemployment. This raises the question which has faced the Commission since it was established: What scope - if any - is there for the effective application of some form of prices and incomes policy as a means of supplementing demand management and longer-run structural policies in the pursuit of sustained high employment with reasonable price stability?

What is meant by a prices and incomes policy? In the context of this paper such a policy is taken to mean an attempt to use some form of direct public pressure to influence decisions about prices and incomes so that these will conform more closely with national economic objectives. The term is sometimes used in a much looser sense to embrace as well many of the structural, competition, and other long-run policies referred to

above, which in recent years have been the administrative responsibility of particular government departments and also, in many cases, the subject of continuing study by the Economic Council of Canada. For purposes of convenience in this discussion of prices and incomes policy, the term is used in its more restricted sense.

A prices and incomes policy is intended to help limit the rise in the average level of domestic prices and costs over the economy as a whole. Price and income criteria of general application, perhaps with some exceptions, must be spelled out for the guidance of those involved in the determination of particular prices and incomes. So far as possible, this should be done on the basis of consultation and consensus involving the principal groups in the economy. Whether reliance is placed mainly on persuasion, mainly on compulsion, or on some combination of both, effective means must be employed for obtaining general compliance with these norms.

Under what circumstances might a reasonable case be made for temporary resort to some form of prices and incomes policy?

A good illustration is provided by the situation facing the Canadian authorities since the outbreak of severe inflation in the mid-'60s. The problem has been how to restore reasonable price stability with as little interruption as possible in the growth of output and employment, and with the aim of getting the economy back

without delay on to a path of sustained expansion at high levels of activity.

Now if the size of price and income increases responded at all quickly and sensitively to restraints on expenditure such as tax increases and a tightening of credit, there is no reason why their moderation should involve severe or prolonged effects on the growth of production and employment. The fact of the matter is, however, that in a country like Canada decisions to raise prices and rates of pay are made by innumerable private groups and public bodies acting on the basis of expectations drawn largely from recent experience. Most of these groups are insulated in varying degrees from the immediate pressure of changing economic conditions and are strongly influenced by the views they have come to hold regarding the probable future trend of prices, the fairness of their share of income, and the increases they expect others to get.

Thus, long after the authorities have acted to reduce spending pressures in an economy in which excess demand has led to severe inflation, jockeying for larger income shares on the assumption that inflation will persist is likely to continue to push up costs and prices to levels well beyond those which market demand can support. The

resulting sluggishness of sales, output and employment then leads to demands that the attempt to control inflation be abandoned as cruel and misguided.

Could some effective form of direct pressure be devised to help moderate the size of price and cost increases in such circumstances? If so, inflation could be checked with less reliance on expenditure restraints, which hold the risk of temporary economic disruption and higher unemployment. And to the extent that price and cost increases could be moderated with greater speed and certainty, the authorities could act to stimulate renewed expansion of economic activity more promptly and with greater confidence of avoiding a recurrence of inflation.

That is the hope which encouraged the Commission in its search for some practical and effective form of prices and incomes policy in Canada over the last two years. It is also the hope that has encouraged similar efforts in many other countries in the last decade.

There are a few general observations arising out of our experience so far which may be of interest.

Important issues arise in deciding what forms of pressure, in addition to persuasion, should be invoked in order to obtain general compliance with the norms of a prices and incomes policy.

It is highly desirable, of course, that the central objectives of such a policy should be widely understood and accepted throughout the community. In a country whose last experience with an incomes policy dates back to the mandatory price and income controls of the Second World War, it is not surprising that we encountered a great deal of misunderstanding about what we were trying to achieve. To the business community, interference with the pricing decisions of management looks suspiciously like a politically-inspired raid on company profits. To professional groups, interference with their fee-setting activities raises the clear possibility that professional standards of service are about to be undermined by ignorant laymen. To organized labor, proposals that the settlement of wage and salary demands through collective bargaining conform with certain broad criteria suggest an anti-union bias. And to some observers, any strong concern with controlling inflation is seen as an irrational phobia which stands in the way of the all-out stimulation of economic activity and employment.

It is not immediately obvious to the public that, for any given rate of productivity change, price increases cannot be reduced unless income increases are also reduced. The price realized from the sale of a product or service is, after all, the source of the incomes received by those

who jointly produce and market it. Thus if the price of a product is to rise less rapidly, somebody's money income will also have to rise less rapidly - either that of the employees, that of the management, stockholders and bondholders, or the incomes of all the groups involved.

The public must also be brought to realize that smaller increases in money incomes need not leave people worse off than before in any real sense so long as they are matched by correspondingly smaller increases in the price level. Thus a five-per-cent increase in annual pay when the cost-of-living is rising by only two per cent a year should be worth every bit as much to an employee as an eight-per-cent pay raise would be if prices were rising by five per cent a year.

Trying to get the public to understand and accept the broad aims of a prices and incomes policy is only one part of the task, however. Many people were critical of the approach followed by the Commission last year on the grounds that it was naive to expect that voluntary restraints would be observed. This was a mis-reading of what the Commission had in mind. We sought to obtain broad agreement on the part of those most directly affected not only on what standards of restraint should apply, but also on the need for effective surveillance and review procedures to determine whether these standards were being observed in

practice. Indeed, we also sought acceptance of the need for governments to bring pressure to bear in order to deal with serious cases of non-compliance.

At the National Conference on Price Stability in February of last year, the Commission was able to obtain broad agreement on these matters so far as the 1970 price restraint program was concerned. Our subsequent experience with this program convinced us that in certain circumstances it was possible to operate a rather informal temporary price restraint program in this country on a reasonably effective basis. On the other hand, not much could be achieved in restraining increases in wages, salaries, rents or other forms of income without adequate recognition of the need for such restraint on the part of those affected and without the strong support of governments to encourage compliance.

The kinds of pressure which have been suggested or tried in order to make a prices and incomes policy effective range all the way from lectures to unfavorable publicity, to tax deterrents, to fines or other forms of legal compulsion directed at those who refuse to comply. It is not surprising that mandatory controls should be regarded as a distasteful last resort in free societies, to be considered only when all avenues of persuasion and appeals for voluntary co-operation have been exhausted. But

however voluntary or mandatory, any incomes policy which aims at exerting some degree of direct control over price and income decisions must find solutions for a number of difficult problems.

For example, if the norms of an incomes policy are to be readily understood, they must be spelled out in very simple terms which are bound to appear rather crude when viewed against the complexities of economic reality and the public's sense of what is fair and equitable. One way of trying to meet this problem might be to permit those administering the program considerable flexibility in the detailed application of these norms to particular situations. On the other hand, there would, of course, be strong objection to allowing too much latitude for administrative discretion. In general, the standards of behavior which are put forward should do as little violence as possible to economic realities and to established institutional procedures for determining prices and incomes.

It has been suggested that these norms might be applied on a selective basis to the more strategic prices and pay structures in the economy rather than across the board. While such an approach has the obvious attraction of administrative simplicity, it raises awkward questions both of economics and of equity. It is by no means the

case that the more spectacular price and income increases originate only in the activities of large firms and large employee groups. Thus, if the control system were limited to these groups they would justifiably regard as inequitable the exemption of the rest of the community from similar obligations.

A major source of difficulty arises from the fact that particular price and income levels are adjusted from time to time as part of an on-going process, and the changes are often substantial. An incomes policy must necessarily intervene in this process at a particular point in time, when certain prices and incomes are bound to be lagging temporarily and others are temporarily ahead of the game. Should these discrepancies be accepted as unavoidable, or should an effort be made to sort them out in applying the newly established norms of incomes policy? A related question is whether the general design of the policy should aim merely at freezing the existing pattern of income distribution for a limited period, or whether it should aim deliberately at effecting certain changes which are regarded as socially desirable.

From what has been said so far, it will be evident that reliance on any form of incomes policy is subject to a variety of limitations.

A fundamental limitation arises from the fact that changes in relative prices and relative rates of pay perform important economic functions, notably those of rationing excess demand out of particular markets and of shifting additional labor and other productive resources to such markets from areas of weaker demand. An incomes policy which seeks to contain increases in the general price level is bound to interfere to a greater or lesser extent with changes in particular prices and incomes and thus with the efficient allocation of productive resources.

These problems may not be unduly serious, however, if the period of intervention is as short as a year or two and if the degree of control imposed is not excessively detailed and inflexible. Certain types of incomes policy which have been suggested, such as the use of tax disincentives to try to discourage the granting of large income increases, are intended to permit enough flexibility so that their use over a longer period of time might be contemplated, although it seems unlikely that major problems of this kind could be entirely avoided.

The extent to which reliance can be placed on some form of incomes policy to contain price and income increases and thereby permit higher employment is also limited by the associated degree of demand pressure to

which the economy is exposed. If market demand pressures are allowed to become generally excessive, the effectiveness of the control system will deteriorate rapidly and its termination will invite an upsurge of suppressed price and cost increases.

This is not to say, however, that temporary intervention to hold down cost and price increases need become ineffective or end in a price and income explosion if applied over a period in which demand pressures are not excessive in any general sense. Under such conditions, an incomes policy may perform the useful service of getting people's expectations and behavior attuned once again to relatively low and stable rates of increase in prices and money incomes.

A third limitation on the use of incomes policy is that by no means all prices and incomes are determined in a way which lends itself to some form of direct control. Obvious examples are the prices of goods sold mainly on world markets, prices established by auction or tender, and the incomes of certain types of self-employed professionals.

In such cases, considerations of equity may lead to the conclusion that the introduction of a prices and incomes policy should be supplemented by appropriate use

of governmental fiscal or regulatory powers to ensure a fair sharing of the burden of restraint.

Given the intractability of the high employment-price stability dilemma and the limited scope for resolving it quickly or easily by other means, the Commission is of the view that an effective and acceptable form of prices and incomes policy in Canada, though by no means costless in economic terms, could serve as a useful supplement to other policies, that it should not be impossible to devise such a policy, and that further effort and innovation in this direction would be justified.

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Prices and incomes commission

Commission des prix et des revenus

May 25, 1971

## Summary of the Submission By The Prices and Incomes Commission To the Standing Senate Committee on National Finance.

- The central problem is how Canada can achieve and maintain an acceptable level of employment without the kind of cost and price increases that prevent this level from being sustained.
- Simply reconciling ourselves to more rapid and chronic inflation than in the past does not in fact offer the ready means of escape from this dilemma that has often been suggested.
- On the other hand, Canadians are right in insisting that some more effective and humane way of resolving our high employment-price stability dilemma must be found than simply to accept average levels of unemployment in the future as high as those of the past.
- There are various lines of attack on the problem, including manpower, regional development, competition and other policies, which over the longer term might help to reduce the minimum levels of unemployment at which our economy can operate without generating substantially larger price and cost increases. Whatever the degree of success achieved through the application of such policies, there will always be some minimum range of unemployment at which an upsurge of price and cost increases in response to excess demand pressures will become a serious risk, so that fiscal, monetary and exchange rate policies will continue to be of central importance.
- A policy to limit the size of price and income increases directly could take various forms. However voluntary or mandatory, any such policy must find acceptable and effective solutions for a number of difficult problems, and it will inevitably be subject to important limitations. Given the intractability of the high employment-price stability dilemma and the limited scope for resolving it quickly or easily by other means, the Commission is of the view that an effective and acceptable form of prices and incomes policy in Canada, though by no means costless in economic terms, could serve as a useful supplement to other policies, that it should not be impossible to devise such a policy, and that further effort and innovation in this direction would be justified.

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